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ABSTRACT

Providing pre-college teachers with an analysis of tax reform is the primary goal of this publication. The present tax system is both inefficient and inequitable. Three goals of tax reform proposals are detailed: (1) fairness--the dimensions of horizontal equity, or equal treatment of equals however defined, and vertical equity, reflecting the degree of the tax structure progress, (2) economic efficiency--the issues of substantial costs, high-low rates, and the appropriate tax base; and (3) simplicity--which may be the first goal sacrificed. These coincide with Adam Smith's goals of equality, certainty, convenience of payment, and economy in collection. Basic features of current tax laws are compared to two major reform plans, the Reagan Plan and the Ways and Means Plan. Advantages of each plan are noted, with the conclusion that the Reagan Plan is preferable with respect to the goals of tax reform. Major reform may have to wait until the budget deficit problem is solved. Tables of federal revenue sources and comparison of current law and reform plans are included. (TRS)

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THINKING ABOUT TAX REFORM

CONTEMPORARY ECONOMIC ISSUES

BY

MICHAEL J. BOSKIN

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THINKING ABOUT TAX REFORM

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Senator Russell Long, one of the most important legislators of recent times on tax legislation, once said that tax reform means, "Don't tax you, don't tax me, tax the fellow behind the tree." The national debate over tax reform has now made its way through several proposals and proposed legislation. Do we need to reform our tax system? Are the proposed reforms an improvement over current law? Could we be doing better? What would be a preferable tax reform?

First, we must understand tax reform in the context of our overall economic problems. Our system of federal corporate and personal income taxation is complex, inefficient, and inequitable. These are serious problems and worthy of correction. However, among our many problems, our rapidly declining international competitiveness, our massive trade and federal fiscal deficits, the enormous difficulties in controlling federal spending, and our long-term productivity growth slowdown are *at least* as important as the problems in our tax code. Tax policy must not be made in a vacuum; it must be coordinated with our overall fiscal, monetary, and regulatory policy. It does seem strange to consider reforming our tax code at a time when we have enormous federal government deficits, stretching as far as the eye can see, on the order of $200 billion or more, about 5% of gross national product (GNP). After all, a major tax reform may not be sustainable because of the potential need for more revenue in the future.

While the current reforms being considered would be the most substantial in many years, they also come rapidly upon the heels of five major tax reforms in less than a decade, and three in the last four years. At that pace, even much maligned tax advisers have difficulty in keeping up with changing legislation. While there are potential gains from tax reform, the cost of major reform is high and rising as we continually change our tax laws. Thus, we should consider making these changes only if we believe we can maintain a stable tax structure over a long enough span of time so our economy can adjust to it. The simplest reform may be no reform at all, which allows people to use the same tax laws over a span of several years.

Adam Smith, the father of modern economics, enunciated four canons of taxation over two centuries ago. It is remarkable that translated into the modern language used to describe tax reform proposals, current tax reformers have the same goals as Smith: equality, certainty, convenience of payment, and economy in collection. Let us deal briefly with each of these goals in turn.

Fairness

Fairness means different things to different people. It has several dimensions, but the two most important relate to how the tax system treats people in similar circumstances and how taxes vary as we move up the scale of economic well-being. The former is usually called horizontal equity, or equal treatment of equals however defined. The latter is usually labeled vertical equity, reflecting the degree of progressivity of the tax structure.

We have all been made aware of various horror stories of some rich people paying no taxes, while some poor people actually continue to pay taxes. We also hear of stories whereby two families in very similar circumstances pay vastly different taxes depending upon their sources of income and the uses they make of their income and assets. To most people, such occurrences are more than anomalies; they reflect, perhaps in an ill-defined sense, a basic inequity in our tax code. We must ask can we achieve horizontal equity? Vertical equity? The first problem in achieving horizontal equity is in defining equal circumstances. Is this to be defined in terms of current household income? Lifetime average income? Income net of certain costs, such as those incurred by second-earners entering the labor force? Consumption, whether current or over a longer span of time? Wealth? There is no objective basis upon which to answer this problem of definition. What makes people well-off is a complicated matter and extends well beyond the realm of just economics and includes important elements of psychology and sociology. Most of us would agree, for example, that at least for those at the very bottom, relative, as well as absolute income matters: in short, poverty may be in part a relative as well as absolute phenomenon.

Economists are used to representing household well-being as a function of the consumption of different goods and services. This may include consumption at different points in their lifetime and also any bequests they may leave. Thus, the definition of the appropriate standard for comparing different individuals may be cause for concern. Otherwise identical households may have made very different investments which worked out well for one family and

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poorly for the other. Should we accord different tax treatment or identical tax treatment when the *ex post* outcomes differ substantially even though the *ex ante* opportunities were identical? This is partly an issue of insurance and economics and partly an issue of ethics. In any event, gross discrepancies in the tax burdens of roughly similarly situated households or firms tend to create enormous public distrust and dissatisfaction with the tax system and should be avoided. Defining exactly how to measure disparities and when they become gross rather than minor will continue to be an important practical issue.

Vertical equity raises ethical and philosophical issues. Many people believe that the tax system should not be used to redistribute income and that tax burdens should be proportional to some measure of ability to pay, such as income or consumption. Others believe that the marginal utility of income declines, and ability to pay out of (in some sense) discretionary income or consumption rises more than proportionally as we move up the income or consumption scale, and thus that tax rates ought to be progressive. More and more, people have come to the conclusion, represented in the current tax bills, that low income people should be excluded form the tax rolls. It makes little sense to spend public money on these individuals and then turn around and tax them through the income tax. Should we have progressive rates? How progressive? In practice, the important goal of economic efficiency impinges upon highly vertical redistribution. This is because in order to get a lot of vertical redistribution, progressive tax rates must eventually be very high and high marginal tax rates stifle economic activity, such as work, saving, investment, and innovation.

Economic Efficiency

In order to raise the revenue to finance government purchases of goods and services and transfer payment to individuals, all governments must levy taxes. While governments can borrow to pay some of their expenses, ultimately future taxpayers will pay higher taxes in order to service the interest on the public debt. An important question then arises concerning how to extract resources sufficient to pay the government's bills from the private sector as efficiently as possible. Efficiency in this sense means much more than just the administrative costs and difficulties of running the tax system. These may be substantial costs, both in terms of the direct cost borne by the government and the cost to taxpayers to comply with the tax laws. However, an even more important set of considerations revolve around the potential distortions the tax system may create in our economy. Consider the types of taxes with which we are most familiar: taxes on incomes, commodities, etc. Each of these affect the costs and returns from engaging in various activities, whether working, investing, saving, or purchasing a particular bundle of goods and services. Therefore, except in the case of a tax levied totally independently of the uses and sources of income, a so-called head or poll tax, all taxes will distort some economic decisions.

It thus becomes important to determine which decisions various taxes distort and how severe the cost is to the economy of having private decision-making affected. When there are many buyers and sellers of a commodity or factor of production, no external costs and benefits associated with production and consumption, and a full set of markets, competitive private markets will allocate resources most efficiently, in the sense that no one can be made better off without making anyone worse off. This is Adam Smith's famous dictum about the invisible hand of the market maximizing society's well-being. For example, individuals, in deciding which investments to make, will seek those investments with the highest returns for the given level of risk. If possible, we would prefer that the tax system interfered in such decisions as little as possible. We want people to make investments based on their inherent economic value, not purely based on tax considerations. Likewise, taxes on income reduce after-tax wage rates and the return to saving, thereby favoring leisure and current consumption over working in the marketplace and future consumption, respectively. An excise tax on a particular commodity, say tobacco, alcohol or gasoline, increases the cost of that commodity relative to others, and reduces the amount consumed.

Economists use the term "deadweight loss" or "efficiency cost" or simply "waste" to describe this decrease in economic well-being due to tax induced distortions of economic decisions. From the examples above, it is clear that two important factors affecting the size of such a distortion are the tax rates themselves, and the responsiveness of the taxed activities to the taxes. If tax rates are very low, there will, in general, be little response to them. As the tax rates rise, relative prices change more radically, and we can expect larger tax induced distortions. Correspondingly, some activities are very sensitive to changes in (after-tax) relative prices or returns, whereas others are less so. For example, in the short-run, the consumption of cigarettes and alcohol may not vary very much for minor changes in their prices, whereas the consumption of ski vacations may be very sensitive to their price. Labor economists after much careful statistical study, have concluded, for example, that the hours of work of primary earners in families are quite insensitive to after-tax wages, whereas those of secondary workers in families are very sensitive to after-tax wages.

A line of research known as the theory of optimal taxation leads to a set of criteria to be used in determining the appropriate tax base, tax rates, and the unit and time period of account, which are the four fundamental decisions one must make in designing a tax structure. The most important conclusion of this research is that high marginal tax rates on price sensitive or return sensitive activities should be avoided.

It is also clear that as the tax system becomes more and more differentiated among income classes, via progressive or rising marginal tax rates, ultimately tax rates must become very high. In order to achieve short-run vertical equity in the tax system, a substantial amount of efficiency may have to be sacrificed because high tax rates on people earning high incomes, who are the most productive in an income earning sense in our society, will restrict their work effort and lead them to attempt to reallocate their activities to receive compensation in a tax exempt form.

In addition to avoiding high marginal tax rates, the major issue in personal taxation is the appropriate tax base. A debate has raged for decades as to the appropriateness of a comprehensive measure of income for use in personal taxation. While arguments date all the way back to Thomas Hobbes preferring consumption or spending to income as the tax base on the ethical postulate that people should be taxed on what they take out of society, roughly measured by their consumption, rather than what they put into it, roughly measured by their income, the debate over income versus consumption tax has been renewed in the last couple of decades. This is because our system of personal taxation has gradually drifted away from taxing income more toward a hybrid of an income and consumption tax. This is most easily understood by realizing that consumption is just income minus saving. Taxing consumption does not necessarily mean taxing commodities via an excise or sales tax. Consumption can be, and in many cases is, taxed in a personal tax, where the base is income minus saving. For example, most countries allow substantial amounts to be set aside tax free for retirement income purposes via employer pre-paid pensions, individual retirement accounts, etc., until the funds are taken out after retirement. Thus, the tax base is income minus the saving in these forms. In the United States, employer pensions, individual retirement accounts, the inside buildup in life insurance, and housing are all important examples of consumption tax treatment of a source or use of income. In these examples the activity is taxed only once, rather than twice as is the case in an income tax, where savings is first taxed as a part of income and again when it earns interest or some other return.

Because saving rises somewhat as we move up the income scale, particularly at the very top, some people oppose taxing consumption on equity grounds. A closer look reveals that this argument is not nearly as strong as might be believed. Data for a single year can be very misleading. If we average people's incomes over a longer span of time, say a decade, or even their whole lifetime, consumption would be almost proportional to income, except at the very top of the income scale. In fact, economists use the concept of permanent or average income, and they have demonstrated that consumption is a better proxy for long-term average income than is current income. Further, progressivity in a consumption tax is possible via the design of the tax rates (although the previously mentioned proviso about avoiding high marginal tax rates still applies).

Different countries use different mixes of personal taxes, excise taxes, and taxes on payrolls (usually to finance social security). Some countries levy taxes on individuals, others on pooled family income or resources. A simple description of the U.S. tax system is presented in Table 1.

How can we get low marginal tax rates? For any given level of revenue, in order to have low marginal tax rates (although perhaps progressive ones), we need to have a very broad tax base, i.e., one that is very comprehensive, whether based on income or consumption. Our current tax system fails in this regard. There are so many exemptions and deductions (many of which go to middle income people, not just wealthy ones) that taxable income in the United States is less than half of all economic income! While many of the exemptions, deductions, and credits in our income tax are there to serve a possi-

bly worthwhile purpose, we have long since outlived the day where, taken collectively, they make any sense. As the tax base has eroded through the years, more and more claims for further erosion have proliferated, placing increased pressure on public revenues. Thus, low marginal tax rates on a broad base are desirable. Many economists prefer a consumption tax to an income tax in this regard, but if tax rates are low enough, and the base is broad enough, this distinction is much less important.

Table 1
Federal Revenue Sources
(Estimated for Fiscal year 1986)

Source	Amount (in Billions)	Percentage of total
Individual Income Taxes	$358.9	37%
Social Security Taxes	289.4	30
Corporation Income Taxes	74.1	8
Excise Taxes	35.0	3
Other	36.2	4
Borrowing	180	18
Total	$973.6	100%

Simplicity

Closely related to administrative costs, equity, and to some extent, economic efficiency, is the simplicity of the tax system. Simplicity has become a buzzword recently among tax reformers. Every year people complain about the costs of filling out their tax forms. Indeed, amazingly enough, in the United States, more people hire tax preparation services than itemize deductions, i.e., many Americans, for whatever reason, paid professional tax preparation services to file the simple short form.

Defining a simple tax is by no means an easy matter. Much confusion surrounds the effect of having many tax brackets. The press seem to think that shrinking the number of brackets from the current fourteen to three or four would greatly simplify the tax system. This is not necessarily so. Nobody has difficulty looking up their tax liability in a a table once they calculate their taxable income. While lower rates or less progressivity may be desirable on other grounds, simplicity is not one of them. It is *much* more important that a given household face the same tax rate, for example, on each of their potential investments than that it face few brackets on the income scale. Further, we live in a complicated world, and economic phenomena are complex. Perhaps the most important example of complexity revolves around the fact that we tend to levy taxes in discrete time periods, such as annually or quarterly, whereas economic events that generate the tax base, such as income, may be very irregular (possibly due to business cycles which cause incomes to fluctuate substantially). Thus, we must deal with the time period of account. Simplicity and fairness may conflict in this regard. The U.S., like most countries, allows people some limited forms of averaging their income and carrying forward and backward losses in computing their taxes. This complicates the tax system, but is "fairer" for many taxpayers. It would be unfair, for example, to tax twin sisters, one of whom was a teacher with a stable income and another a commissioned sales person with a widely fluctuating income, in a progressive tax system which does not allow income averaging. Most of us would agree that if their average income was the same, say over 5 years, they ought to pay the same tax. But a progressive tax system with no income averaging would create a larger tax burden for the one with the fluctuating income.

Our tax system has become quite complex, partly because of specific exemptions and credits, but also because of a large number of opportunities to shift income through time, between individuals or family members subject to different tax rates, etc., in order to reduce tax burdens. It should be expected that individuals will attempt to minimize their taxes, other things being equal. Thus, again, a more comprehensive tax system may be much more simple to administer, limiting the avenues of tax avoidance, but may be perceived as unfair because it does not distinguish among different households on various grounds. Simplicity may be desirable, but it is generally among the first goal of taxation sacrificed in tax reform.

Evaluation of the Current Proposals

Various tax reform proposals have been introduced in the last few years. The most important of these involve either a fundamental reform of our personal and corporate incomes taxes, or the institution of a new tax in order to remove some of the most (allegedly) abusive features of our existing tax laws. Usually, the new tax proposed is some form of consumption tax, such as a value-added tax (VAT), which is quite widespread in Western Europe. A VAT is like a national retail sales tax, but rather than being levied only at the retail level, it is levied on the increment to value added at each stage of production, for example, from basic manufacturing to distribution to retailing. If there were few exemptions in the VAT, its base would be quite broad, reflecting the total value of consumption in our economy, which is close to $3 trillion. Each percentage point of value-added taxation could gain between $25 and $30 billion, and thus could be used to close the deficit and/or to remove various features of our personal and corporate income tax system which are considered damaging. One example would be to impose a modest value-added tax (say 5%) and use the revenue to lower tax rates in the income tax, both corporate and personal. This proposal, which surfaces every few years, generally has been supplanted in the recent political debate by a desire for comprehensive revision of the personal and corporate income taxes without a new tax device. It is possible, however, that if and when the tax reform debate gets to the stage of legislation in the United States Senate that a value-added type tax will be reintroduced.

What of the reforms of the personal and corporate income taxes? A variety of proposals such as those by Senator Bradley and Representative Gephardt and Representative Kemp and Senator Kasten call for a substantial flattening and lowering of tax rates and broadening the base by eliminating many credits, deductions, and exemptions. These reforms are designed to distribute the burdens more equitably and make the economy more efficient while raising the same amount of revenue as current law. These original tax reform proposals called respectively the FAIR Tax and the FAST (for "Fair and Simple Tax") form the backdrop in the early 1980s for the tax reform proposals now before the country. In November of 1984, the Treasury Department issued a set of proposals to the President for his consideration. Again, the theme was to sharply reduce personal and corporate tax rates, while broadening the tax base. The Treasury proposal, however, sharply increases taxes on investment and saving, while moving toward a more level taxation among types of investment. It also financed a substantial personal tax cut by a big corporate tax increase. Since we have already had a substantial personal tax cut in 1981-83 of approximately 25%, the propriety of another has been called into question by many people, not just the business community. In May 1985, the President issued his set of proposals to the Congress, called "Tax Reform for Fairness, Growth and Simplicity." In some regards, it followed the Treasury's original proposals closely, in others, it deviated substantially. As Table 2 shows, the President's proposals slowed depreciation somewhat relative to current law, but not nearly as much as would the original Treasury proposals or Bradley/Gephardt. The fourteen bracket rates were reduced to three: 15, 25 and 35%, but a variety of deductions were eliminated, including that for state and local taxes paid. Thus, in high tax states, some individuals would not have received a reduction in their *combined* state and federal marginal tax rates. The President also would have taxed some fringe benefits which are untaxed under current law, restricted the potential for certain abuses in the tax system, abolished income averaging, eliminated the investment tax credit on new equipment purchases, and raised the personal exemption to $2,000 (and the zero bracket amount as well), thereby eliminating those below the poverty line on the tax rolls, etc.

Thus, the President's proposals contain many desirable features. They would broaden the tax base, while lowering tax rates, a generally desirable goal of tax reform. While they eliminate the investment tax credit, they still allow a form of accelerated depreciation, and importantly, recognize that inflation erodes the value of those deductions by indexing the cost of the asset to be depreciated against inflation. The President retained a small part of the Treasury's original proposal to allow corporations to deduct 50% of their dividends by allowing a 10% dividend paid deduction to establish the principle that dividends should not be fully taxed twice, once at the corporate level, and again at the personal level. The President's proposals would also dramatically change the tax treatment of specific industries, hitting particularly hard at financial institutions, such as banks, the energy industry, timber, and defense contractors in multi-period construction, and life insurance. These industry-specific tax reforms were designed to equalize the tax burden on new investment in different industries. The extent to which this would be achieved is highly debatable, since there are innumerable difficulties in attempting to measure the effective marginal tax rate on new investment. These difficulties

include measuring true depreciation properly, accounting for differential riskiness across industries, dealing with differential access to debt finance by types of assets and industries and so on. The basic goal was to remove the tax system in considerations of investor decisions. This goal is laudable, and the President's proposals went far in this direction, although it is difficult to evaluate whether it would achieve complete neutrality. Because the President ruled out disallowing mortgage interest deductions, distortions between the favorable tax treatment of housing and tangible business investment remain. The distortion favoring consumption over investment also remains, although it is not as bad as in the Treasury's original proposals, which were heavily anti-investment.

Table 2

Comparison of Current Law and Major Reform Plans

	Current Law	Reagan Plan	Ways & Means
Individual tax rates	14 rates from 11% to 50%	3 rates: 15, 25, 35%	4 rates: 15, 25, 35, 38%
Personal exemption	$1,080	$2,000	$1,500 for itemizers $2,000 for non-itemizers
Mortgage interest	Fully deductible for all mortgages	Principal residence deductible	Principal and second residence deductible
Other interest	$10,000 plus amount equal to investment income	$5,000 plus amount equal to investment income	$20,000 plus amount equal to investment income, cap on tax shelters
Employer-provided health insurance	Not taxed	Taxed up to first $10/month for single; $25 for family	Not taxed
Charitable contribution	Fully deductible	Deductible, but only on itemized returns	Fully deductible for itemizers, partly for non-itemizers
State and local taxes	Fully deductible	No deduction	Fully deductible
Capital gains	60% excluded for 20% top rate	50% excluded for 17.5% top rate but fewer items covered	42% excluded for 22% top rate in 1987
Corporate tax rates	46% top, graduated rates up to $100,000	33% top rate, graduated rates up to $75,000	36% top, graduated rates up to $75,000
Depreciation	Accelerated	Somewhat accelerated, but less generous than current law	Slower depreciation; indexed for inflation
Investment tax credit (ITC)	Generally 10%	Eliminated	Eliminated
Alternative minimum tax	Modest	Strong	Very Strong

The basic features of the President's proposals were the starting point for the Ways and Means Committee in the House of Representatives – the Congressional committee charged with initiating tax legislation. As Table 2 indicates, rather than the President's three brackets, Ways and Means added a fourth at 38%. Also, the brackets are broader, so upper middle income professional people in the $45,000 to $75,000 range get very little reduction in their marginal tax rates. Ways and Means also backed off from disallowing state and local tax deductibility, and reduced a variety of other potential revenue raisers, such as taxing some fringe benefits. In order to make up the revenue lost by doing so in addition to the additional higher tax bracket in the personal tax, the reduction in the corporate tax rate is to 36%, rather than to 33% as in the President's bill. The Ways and Means Committee, like the President, proposes eliminating the investment tax credit. It also proposes a very dramatic slowdown in depreciation, which combined with the elimination of the investment tax credit would substantially increase the cost of capital for new investment, and therefore, would threaten capital formation in our economy at a time when large public deficits are leaving greater liabilities to our children and grandchildren. The Ways and Means bill also compromises on a variety of other industry-specific issues. The one real improvement in the Ways and Means bill over the President's was the elimination of the poor from the tax rolls in a more target effective manner in terms of the revenue lost. The increased exemption is reduced for itemizers, those with upper incomes. This will save substantial revenue, while achieving the same goal.

Where do these two proposals stand with respect to goals of tax reform described above? Each attempts to equalize the tax rates across types of investments. I believe the President's proposals do a somewhat better job than Ways and Means in this regard, and it is certainly vastly superior with respect to neutrality between consumption today and investment, a much more important form of neutrality. Marginal tax rates are reduced, but less than meets the eye because of the elimination of various deductions and the size of the tax brackets. Some base broadening occurs, although much less than intended in more comprehensive reform proposals. Such is the political necessity, perhaps, of attempting something as basic as the complete overhaul of our nation's tax law. While there are many small abuses that occur which a consensus thinks should be removed, in any of the big ticket items, there is sure to be enormous debate and disagreement. It remains to be seen whether tax reform will pass in the near future. It may well be that at a time of substantial deficits that the constituents are right: they fear losing their deductions without really getting a decrease in rates because the rates will have to rise again to deal with the deficit. Thus, structural tax reform and deficits are not totally separable issues.

Our present tax system is inefficient and inequitable. It is an important, although not pressing, social problem. We should be moving toward a more efficient and equitable tax system, but it may be too difficult to do so via a total rewriting of our personal and corporate income tax at a time of large budgetary deficits. Perhaps we will achieve some bipartisan compromise and pass tax reform in 1986, but it is more likely that major reform will have to wait until the budget deficit problem is solved and/or a greater consensus can be reached on the nature of that reform. It may well be that we ultimately must seek a different tax in order to finance the reductions in income tax rates that we would all like to see. At least this way, perhaps the marginal revenue, if not our total tax take, can come from an efficient and equitable tax.

Questions

1. Why is simplicity so difficult to achieve in our tax system?
2. List the goals of tax reform.
3. Should we use tax policy to promote social objectives? If so, which ones and why?
4. "Lowering marginal tax rates for those at the top of the income scale does no good for the economy, but is simply a tax break for the rich." Comment.
5. What are the basic features of any tax system? List two ways each of them affects each basic goal of tax reform.

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